

## APPENDIX

Notes for FOMC Meeting

October 6, 1992

William J. McDonough

The foreign exchange markets have been unusually turbulent since the last meeting, dominated by a partial collapse of the European Monetary System.

You will recall that at the last meeting we discussed intervention operations and the view of the Federal Reserve that further dollar-support operations would be expected by the market, would not have a high likelihood of achieving a goal of strengthening the dollar and could be counterproductive. I reported that we had been actively seeking to convince the Treasury of that opinion.

On the Friday after the meeting, August 21, the Treasury wished to avoid the dollar passing through the then all-time low against the mark. Despite very strong advice from me, representing the views of the Federal Reserve, the Treasury instructed the desk to organize a coordinated intervention. The Federal Reserve had only two choices: either to have the desk intervene for the Treasury alone, as we had once earlier this year, or to participate in the intervention. If we did not join the Treasury, we believed that it would be even worse than an ill-advised intervention. It would become public sooner or later, that the American monetary authorities were split at a time when the dollar was weak and the European monetary system was showing ever greater signs of stress. We made the decision, approved by the Chairman, that the wiser choice was to join the Treasury. Together we bought \$300 million against German marks; seventeen other central

625

banks bought just over an additional    After a brief  
lift, the dollar dropped further and set a new low of DM1.4255 later  
that day.

The following Monday, we had a repeat. Against very strong advice from the Federal Reserve, the Treasury again instructed the desk to organize a coordinated intervention. Faced with the same choice, the Federal Reserve chose to keep the American authorities united and joined in the intervention. The desk bought \$200 million against marks, while other central banks bought

We had authorization to buy up to \$300 million. Even during the intervention, the dollar continued to fall and I stopped our intervention, with the later agreement of the Treasury, rather than risk further damage from a counterproductive effort. The Treasury has not directed any intervention since that time. The dollar reached its new all-time low of DM1.3865 on September 2.

The dollar strengthened during the partial collapse of the EMS, reaching a high of DM1.5116 the day that sterling left the ERM. After at least the temporary lull in that storm, dollar/DM interest rate differentials became the most important driver and the dollar settled back to a range of about DM1.3950 to 1.42.

The only other operations during the period took place on September 8, when the Swedish central bank, in the midst of a strong speculative run on their currency, ran out of Deutsche Mark reserves and asked the Federal Reserve to help them by entering an off-market transaction in which we would sell them the DM equivalent of \$400 million. In addition to helping the Swedes, this kept them out of the market in what would have been a possibly destabilizing dumping of

dollars. On behalf of the Foreign Currency Subcommittee of the FOMC, Chairman Greenspan authorized the transaction. This clearance covered both approval to exceed a change in a single day of more than \$150 million in net Federal Reserve System holdings of a single foreign currency and to accommodate this transaction in the limit for the change in the overall open position in foreign currency holdings since the previous meeting.

In the interest of time, I will not attempt to describe the details of the partial fracturing of the EMS, but will cover only some of what happened and then comment on it.

As you are aware, the EMS was created in 1979 as a system of fixed, but adjustable exchange rates in which occasional parity realignments took place. However, there was no currency realignment between January 1987 and last September 13, despite widely different macroeconomic performance between the Germans, Belgians, Dutch, Danes and French on one side and the United Kingdom, Italy, Spain, Portugal and Ireland on the other. German economic performance after the unification of the country, characterized by large budget deficits, above-target monetary expansion, growing inflation and resulting very high interest rates, forced its neighbors to have growth-inhibiting high interest rates in order to maintain parities. The weak cyclical positions of some of the countries made the costs of maintaining high interest rates increasingly difficult to bear. The Europeans had hoped to avoid realignment until at least the French referendum on the Maastricht Treaty, scheduled for September 20, but the market did not permit that. First, the market moved on the Italian lira; a response of a 7% devaluation of the lira on September 13 and relatively small

interest rate reductions by Germany the following day accomplished little or nothing. After very heavy losses of reserves, the British had to pull out of the exchange rate mechanism on September 16, followed by the Italians. The Irish, Spanish and Portuguese introduced exchange controls. And the French

in a so-far successful effort to maintain the franc within its limits vis-a-vis the mark. Very strong pressures remain within the EMS.

Most attention now is on whether the French are able to maintain their parity with the DM. Perhaps they can, since macroeconomic performance comparisons in fact favor the French franc over the DM. However, even the short-term fight is not over when the French have to keep call money at levels well over those of Germany to put a high price on short positions.

Even if the franc can be defended, there will be serious problems following. France has a very large positive trade balance with the United Kingdom, which will surely deteriorate after the U.K. float and effective, if not formal, devaluation. Similarly, the Irish stay tied to the DM, even though about one third of their exports go to the U.K. Apparent solutions to today's problems merely create new ones for tomorrow.

With the French finance minister reminding the world that speculators during the French Revolution went to the guillotine, it is worth noting that the market attack on a cascade of currencies was not only the old-fashioned combination of leads and lags and the assault of market professionals such as commercial banks. However, from what we know of bank foreign exchange profits in the third

quarter, soon to be announced, Monsieur Sapin will no doubt order the guillotine mounted on the Place de la Concorde.

A major additional factor is that the apparent stability of a fixed-rate system convinced many investors, especially fund managers, that there was little or no exchange risk in high-interest-rate currencies. Over a period of months or even years, they invested in high-yield EMS currencies and those of other countries tied to the system through the ECU, especially Finland and Sweden. When concern about exchange rate stability grew as the French referendum approached, these investors began to move into stronger currencies. After the inadequate policy response of the small Italian devaluation and the small interest rate moves by Germany, many of these investors went roaring toward the same exit and ordered their commercial or investment banks to get them out of their foreign exchange positions immediately at virtually any exchange rate. We believe this was the most important factor, at least at the margin, in the huge runs on various currencies and the inability of traditional defenses, such as intervention and interest rate moves, to thwart them.

As at least some of these investors moved out of European assets, they moved a portion into Japan, strengthening the yen against both the dollar and the mark. Last week, the dollar reached a new all-time low against the yen of 118.60. Japanese authorities and their manufacturing exporters are starting to worry about an excessively strong yen giving them the problem that gave the rust belt its name in the early '80s. In addition, most of the recent money moving into Japan is in short-term liquid deposits and could move out as quickly as it moved in.

Runs against a currency have not been peculiar to Europe. Growing worries about Canada's constitutional future, on top of a weak economy, have caused a run on the Canadian dollar. The Bank of Canada confronted the run with intervention and increases in official interest rates of almost 2 percentage points. Last week, the Canadian chartered banks increased their equivalent of the prime rate by 200 basis points.

Looking at our own situation, the dollar has been weak this year because of interest rate differentials with Europe. But it has been particularly weak when there has been concern about the strength of the recovery, and Mr. Perot's candidacy has made foreigners worry about our political future.

Regarding interest rate differentials, the market interpreted the lack of action by the open market desk last Friday as meaning that Fed policy is on hold until this meeting. It is anticipating an ease and has built into the exchange rates a 25 basis point cut in the funds rate.

The market is also confused about German monetary policy and may just be reading it wrong. After lowering interest rates in concert with the Italian devaluation, the Bundesbank was very tender about the wide questioning of whether it had maintained its independence. I believe that at least some of the key directors feel that they are well on their way to having established to their own satisfaction that any interest rate moves will be deemed to be of their own free doing. Although last week the Bundesbank maintained the discount and Lombard rates at existing high levels, it lowered the call money rate to 8.9%, 80 basis points below where it was three

weeks ago. Schlesinger emphasized this development at his press conference last Friday. This may be the first fair-sized step towards easier monetary policy. One of the reasons behind such a possibility is that the Bundesbank achieved its goal of restoring flexibility to the EMS and lessening the likelihood that they would lose control of monetary policy as they did in September. During last month, the Bundesbank added 92 billion marks to reserves through intervention operations, an amount equal to the total reserves of the German banking system at the start of the month or approximately 25% of the Bundesbank's total assets. Sterilization took the Bundesbank longer than it would take us because of the relatively inflexible nature of their basic four-and eight-week monetary operations. However, the experience has clearly contributed to a change in operations, announced Friday, to the use of two-week maturity operations and a willingness to use operations as short as a few days.

If the Bundesbank wishes to ease, and yet appear independent from political pressures, it can point to the weakening of the German economy, slightly improving price performance and all kinds of people explaining the rapid M-3 growth is a technical result of their inverted yield curve as justifications. Mind you, if the Bundesbank is at the beginning of an easing period, they are likely to proceed with considerable caution and rather slowly.

Regarding the U.S. economy, growth of the kind envisioned in the Greenbook forecast will not help capital flows into the United States, because such flows require a stronger growth pattern. Perot's candidacy and a growing market view that a Clinton victory is at least a possibility and would probably bring a fiscal stimulus package early



next year create uncertainty, also adversely affecting capital flows. The worry has to be that these pressures, in a world in which recent history shows how rapidly large capital flows can move out of a country, would trigger what could be a rather rapid weakening of the dollar. I do not believe that there is a single contingency plan for such an event, because it could happen in a variety of ways, or, in the best of cases, not at all. We have to be very vigilant and are keeping particularly close to those market participants who see such asset reallocation moves early.

RECOMMENDATION:

Mr. Chairman, we need a motion to approve the three operations I have discussed: the sale of German mark reserves to buy \$150 million in the intervention operation August 21 and \$100 million on August 24 and the sale of the equivalent of \$400 million in marks on September 8 to the Swedish central bank.

Notes for FOMC Meeting  
October 6, 1992  
Joan E. Lovett

Domestic Desk operations were at first geared to maintaining the existing degree of reserve pressure and then to imparting an easing of those pressures on September 4 in response to weak employment data and sluggish money supply behavior. Thus, Fed funds initially were expected to continue in the 3 1/4 percent area, moving down to 3 percent in association with the September 4 easing. The borrowing allowance was cut twice by \$25 million, bringing the level to \$200 million. The first was a technical adjustment to seasonal reductions in use, and the second was made in conjunction with the change in policy stance. Borrowing ran above the allowance during the period, averaging \$273 million. This reflected a couple of statement date bulges when reserves fell short of expectations.

The Desk was active throughout the intermeeting period, seeking to meet large reserve needs with a variety of temporary transactions as well as with permanent additions to the portfolio. A large seasonal need for additional reserves was anticipated at the outset, stemming from increases in currency and required reserves early in the period and rising Treasury balances later in the interval. Against this background, the Desk purchased \$3.7 billion of Treasury coupon issues in the market on September 1 and purchased additional securities

directly from foreign accounts periodically thereafter. The System's portfolio rose by a total of \$6.2 billion, consisting of \$5.6 billion of coupon issues and \$0.7 billion of bills.

As September progressed, reserve needs exceeded initial expectations considerably: currency growth was somewhat stronger, and Treasury balances were substantially higher following the mid-month tax date. Although Treasury cut back considerably on its auctions, Treasury balances at the Fed ended the quarter at about \$25 billion versus estimates of about \$13 billion made at mid-month. General balances came in just under \$60 billion. Individual nonwithheld income taxes were stronger than expected, and RTC receipts were also somewhat above expectations. The higher balances were a surprise to the market as well and led to reduced estimates of Treasury's 4th quarter borrowing requirements.

In meeting reserve needs, the Desk used a mix of RP's ranging from customer-related to multi-day System operations. The multi-day RP's were a combination of withdrawable and fixed term, depending on the outlook, and included one operation that was preannounced. With the money market generally to the firm side, Desk operations were constrained on only a few occasions by the need to insure market clarity about policy rather than optimal reserve management. For the most part, the Desk was able to inject the estimated volume of needed reserves--acting on all but four days of the period--but reserve shortfalls tended to keep a firm bias to the money market. The quarter-end also saw a

firming trend, exacerbated by the confluent ending of a reserve maintenance period and auction settlement. In all, the Federal funds rate averaged 3.22 percent for the intermeeting period from September 4 on.

Although Federal funds were often above the expected level, there was no uncertainty among market participants as to the desired level. There were, however, shifting views over the period about the System's next move. A bout of dollar weakness at the outset was seen as impeding a Fed ease. As the dollar stabilized, the focus returned to the stagnant state of the economy. Participants reasoned that, while foreign exchange market developments were a significant factor such that the Fed would not act while the dollar was unsettled, the domestic economy would remain the Fed's top priority. Thus, yields dropped quickly and dramatically on the weakness evident in the August employment report announced on September 4 as the market anticipated that the System would feel compelled to ease. The foreign exchange market became even more of a key focus over much of September given the turmoil in the ERM. The turbulence in that market had, on balance, only a limited impact on Treasury market yields given the dollar's relative calm. Meanwhile, data continued to portray an economy struggling to grow, and this imparted a downward bias to yields, particularly later in the period. In this setting, participants expected a weak employment report on October 2 to be the catalyst for further System ease. In fact, incoming information was viewed as so soft that

additional Fed ease was already built into the rate structure prior to the employment report. That report was viewed as weak-- not so weak as to trigger a move prior to today's FOMC meeting but weak enough to leave expectations of an imminent move in place.

In the coupon sector, rates on short- and intermediate-term issues ended the period 25 to 55 basis points lower. Rates on the long bond ended only a few basis points lower. The Treasury raised a net of \$22 billion in the coupon sector during the interval including the initial "Dutch" auctions of two- and five-year notes that will comprise the Treasury's year-long experiment with this format. That experiment was announced on September 3 and is designed to test whether the single price format will prove beneficial in terms of taxpayer cost and auction participation. Demand for the 2-year note was strong and only a small percentage was awarded at the stop-out rate, a level that was right on the market. The initial 5-year note auction, on the other hand, could be considered a disappointment. Demand was lackluster, and the stop-out was several basis points above 1:00 p.m. market levels. However, this may better be viewed as a necessary cost to getting the format launched.

Rates in the long end of the market declined with the rest of the curve when economic data looked particularly weak. The 30-year bond reached its interperiod low of 7.23 percent right after the System's ease on September 4. Declines in this sector were subsequently tempered by uncertainty related to the

upcoming Presidential election. Initially, prospects of a Clinton victory were seen as more likely to generate a move to fiscal stimulus. By the end of the period, a fiscal package looked likely no matter who wins, the only difference being one of size and timing. Market uneasiness about such prospects reflected the belief that it is impossible in the United States to reverse Government spending once it is initiated. Yield declines were also tempered by the huge outpouring of corporate debt that was issued after the Labor Day holiday and following the Fed's easing move. Some \$36 billion was marketed during the period and required time to distribute. Sales of Treasuries as hedges against unsold corporate inventories led to some market scarcities, most notably for the Treasury's 10-year note.

Bill rates were lower by 40 to 45 basis points over the period. The Treasury paid down \$7.3 billion in the bill sector during the interval (including yesterday's auction) amid rising cash levels. The short-end got an added fillip during periodic but brief quality spurts. New three- and six-month bills were sold yesterday at rates of 2.67 and 2.78 percent, respectively, compared with 3.10 and 3.18 percent just prior to the last meeting. Rates on private short-term instruments were lower by 20 to 30 basis points.

Michael J. Prell  
October 6, 1992

FOMC BRIEFING -- DOMESTIC ECONOMIC OUTLOOK

As best we can judge at this point, real GDP grew at a rate in the third quarter somewhere in the vicinity of the 1.6 percent average pace of the first five quarters of this recovery. Such an outcome would be in line with our expectations at the time of the last meeting.

Even so, as you are aware, we've sliced more than a percentage point off the growth rate projected for the current quarter and sizable fractions off the rates in the first half of next year. Moreover, we've raised the unemployment rate disproportionately relative to the trimming of GDP. I'd like to spend a few minutes reviewing the logic underlying these revisions to the forecast.

The first point is that the available indicators suggest a weak output trajectory as we begin the fourth quarter. Most notably, employment has fallen off late, and industrial production appears to have declined another third of a percent last month. Unless things turn around soon, both of these variables are likely to be down on a quarterly average basis in the current period--far below the path anticipated in the August Greenbook.

A turnaround certainly is possible, but--and this is my second point--developments in the household sector don't make it look likely. Although we estimate that real consumer spending rose appreciably in the third quarter, that gain largely reflects a spurt in non-auto retail sales at the beginning of the summer. Recent data give no hint of sustained strength, and the latest indications of wage and salary income and consumer sentiment don't bode well for



future spending. Meanwhile, the housing market indicators have been a bit confusing of late, but on the whole they suggest that the decline in mortgage rates has produced only a modest improvement in that sector. It seems doubtful that the economy is going to build up much steam until households become more inclined to spend.

This brings me to point three, which is that households probably won't open their wallets wider until they are more confident about their economic prospects. It is here that the circularity--or, in technical jargon, the simultaneity--of the problem becomes apparent: People won't spend much until they feel more secure about their jobs and income, but the potential for generating additional purchasing power is limited as long as people hesitate to spend.

Moreover--and this is point four--such increases in demand as we have experienced to date in this recovery have not translated into job growth. Instead, productivity gains have more than accounted for all of the increase in output. To be sure, it is the norm for labor productivity to surge in the early part of a cyclical upswing, because companies typically have hoarded some labor during the recession and are able to operate more efficiently as they move back toward more normal rates of output. But, in a more typical recovery, demand is strong enough to require significant increments to employment as well.

My fifth point is that, while the pickup in productivity thus far in the recovery seems to be on track with previous relationships, the extent of restructuring going on in many industries suggests to us that output per hour may rise relatively rapidly for a while longer, thereby damping new hiring. The

adjustment we've made to the forecast in this regard accounts for the extra elevation of the unemployment rate that I noted earlier.

So, in sum, the downward adjustment to the near-term GDP forecast reflects not only a recognition of recent weakness in employment and industrial production, but also a reassessment of the prospects for household spending in light of the employment-dampening effects of relatively strong productivity gains. A more sluggish path of consumption in turn diminishes the incentive for business investment.

That said, why have we stuck with the projection of a significant acceleration of activity over the course of 1993? One senses that a good many consumers and businessmen are becoming skeptical about the predictions that better times are just around the corner, and economic forecasters are becoming increasingly wary about sticking with this story and just changing the dates. But, while admitting that the pickup and, especially, its timing are far from assured, we still believe the analysis makes good sense.

The projection of an acceleration of activity next year is founded in part on the belief that the "headwinds" associated with a number of sectoral problems and financial stresses will be diminishing over time. In addition, though, we are projecting that longer-term interest rates will decline substantially further by next spring, with the 30-year Treasury rate falling to around 6-1/2 percent. This should aid the balance sheet restructuring process and--more generally--provide impetus to demand.

Obviously, an important question is what funds rate change, if any, might be necessary to bring about this easing of longer-term yields. As we hinted in the Greenbook, we have anticipated that the

funds rate might move a little lower, but we would expect longer-term rates to fall appreciably even if the funds rate were to remain at 3 percent. Investors' expectations undoubtedly are influenced by their experience. And the longer short-term rates remain low and inflation remains subdued, the less investors will worry that rates will be headed higher in the future and the more willing they will be to accept lower bond yields. It is interesting to note that our quarterly econometric model, which--like many others--embodies such a formulation of term structure behavior, has done well in tracking the shape of the yield curve to date...and it would suggest that bond yields should come down over the next couple of years even more than we've predicted.

Having uttered the word "inflation" a few seconds ago, I should say that the silver lining in our forecast of distressingly high unemployment is that we seem to be making solid progress toward price stability. The CPI is projected to be rising at only a 2 percent annual rate at the end of 1994, and with joblessness still in the high 6s at that point, output growth could remain above potential through 1995 and 1996 while the inflation trend drifts into the 1 to 1-1/2 percent range.

But this may be getting too far ahead of the game. The more immediate question would seem to be whether activity will in fact pick up fairly soon, or whether we are facing a more serious stalling out than suggested by the Greenbook. If the latter, and if a significant and prompt fiscal stimulus--or some autonomous jolt of animal spirits--is not in the cards, then our analysis would suggest that a sizable further easing action may be needed in the next few months to recharge the economy.

There is an understandable tendency to look at the state of the economy after almost 700 basis points of easing and conclude that more cuts won't do much good. However, I'm more inclined to think that the 300 basis points left before we get to zero do provide the scope for meaningful action. It may be worth noting, in this regard, that, even a funds rate in, say, the 1 to 2 percent range would not be unprecedentedly low in real terms. The way the markets would react to such a drop obviously would depend on the context--but I suspect that, if it occurred as the unemployment rate was moving up toward 8 percent, any loss of anti-inflationary credibility would be minor, and remediable with a timely tightening once things began to pick up.

Obviously, in thinking about the prospects for the economy and for market responses to policy actions, the external sector is of particular interest at present, and Ted has a few words to say in that regard.

\*\*\*\*\*

October 6, 1992  
E. M. Truman

FOMC Presentation -- International Developments

My original intention in this briefing was to present an insightful analysis of the deep implications for the U.S. economy and the staff forecast of the recent exchange market and financial turmoil in Europe. However, it still is exceedingly unclear how these events will play out. Moreover, as far as we can tell, the effects on the U.S. economy of what has happened to date are minimal.

While exchange rate relationships within Europe have changed, the principal development from the economic perspective of the United States has been a slight easing of European monetary conditions accompanied by a somewhat stronger dollar. Most empirical models imply only modest effects on U.S. real activity from an episode of this type: the income effect from stronger growth as a result of the easier monetary policy is generally offset by the negative substitution effects from the stronger dollar. The estimated effects on U.S. inflation typically are small as well. We have incorporated this conventional insight into the staff forecast.

One alternative assumption would be that continued turmoil within Europe will generate substantial uncertainty that, in turn, works to reduce investment in Europe and to bid up the dollar; in that case, both income and price effects would be working in the same direction and would be negative for U.S. activity.

Several other developments have affected our outlook for the external sector.

Notwithstanding the positive effects on European growth associated with ERM developments, on balance, we have marked down growth in the foreign industrial countries, with the important exception of Japan. The larger-than-expected Japanese fiscal package boosted our outlook for 1993, but we remain pessimistic about the near-term situation, with growth over the second half of this year projected at less than one percent at an annual rate. We also have marked down our projection of economic activity in developing countries. The net result of all these changes, using U.S. export weights, is about a half a percent less foreign economic growth this year and a quarter of a percent next year.

As noted, we raised slightly our projected path for the foreign exchange value of the dollar. This morning, the dollar on average -- and I would emphasize on average -- is 1-1/2 percent above its level at the time of the August FOMC meeting, and about 5-1/2 percent above its low of a month ago.

The dollar's decline since last January, about 5 percent in real terms, has been accompanied by a decline in the differential between U.S. and foreign real long-term interest rates of about 50 basis points. This is broadly consistent with normal statistical relationships between interest rates and the dollar's value. One question is whether the decline in the dollar is boosting the recovery of the U.S. economy, that is, providing the expected channel for the effects of Federal Reserve

ease. My tentative answer to this question is affirmative. I would note, however, that over the past nine months, during which the dollar has declined by 5 percent in real terms, we have lowered our estimate of foreign economic activity for 1992-93 by a cumulative 1-3/4 percentage points. In the near term, such a reduction in foreign growth normally would be expected largely to offset the lower dollar. However, over the longer run, the effects of the lower dollar should predominate because relative price effects work their way through the system with longer lags.

We have raised our assumption about oil prices by about a dollar a barrel. The major factor behind this adjustment is a postponement of the assumed flow of Iraqi oil to world markets from early in 1993 to the second half of the year. Gazing a bit further out, it appears that Iran is increasing its potential production somewhat more than had been previously expected, and this could produce a down-side risk to our price forecast after Iraqi production becomes available.

Information for the second quarter that became available since your last meeting suggests a somewhat weaker underlying level of net exports of real goods and services. However, conditioned on the new Q2 information, the merchandise trade data for July contained relatively few surprises, aside from a further rise in imports of computers and parts. We continue to expect somewhat larger deficits in coming months.

The net result of all these factors is that real net exports of goods and services are projected to provide only a very slight boost to U.S. real GDP over the forecast period. A

moderate improvement in services is almost offset by a small deterioration in goods.

That completes our report.



October 6, 1992

FOMC Briefing  
Donald L. Kohn

Perhaps in contrast to the tone of much of the nonfinancial data received since the last Committee meeting, some financial market indicators of the thrust of monetary policy have turned more positive in recent months, showing the effects of the easings over the summer. Broad money growth picked up in August and September, with M2 expanding at a 3 percent pace, following declines on balance over the previous four months. Credit flows may also be showing a few tentative signs of life. Though data are very limited, we are estimating that debt growth for nonfederal sectors, while still anemic, strengthened a bit over the third quarter. After showing very little change in late spring and early summer, bank credit picked up to 5-1/2 percent in August and September, including the first increase in business loans in a year. Moreover, the easings have shown through to real interest rates: The one-year rates shown in the chart package have moved down noticeably and are at their lowest levels in a dozen years; long-term real rates at the 10-year maturity used in that package also appear to have declined and are below their levels of most of the 1980s and 1990s. And the dollar's weighted average foreign exchange value remains close to, though somewhat above, its historical low.

These indicators, while somewhat encouraging in their implications for economic expansion ahead, do need to be interpreted cautiously. With regard to credit and money flows, growth rates remain quite low--broad money aggregates are below their annual ranges and debt is only a little above the lower bound of its range. Moreover, at least with regard to money, recent strength may not be sustained. The bluebook has M2 and M3 slowing a little in coming months

from their recent pace under the unchanged interest rates of alternative B. Expansion of the aggregates should be supported by some special factors--specifically, mortgage refinancing and the unwinding of the First Union reserve avoidance scheme--but underlying growth will be damped by sluggish increases in nominal income, and velocities will continue to be boosted by downward adjustment of deposit rates and the tug of capital market investments and debt repayment. As a consequence, we are projecting that both M2 and M3 will come in a half percentage point short of their 1992 annual ranges. Moreover, capital markets are quite skittish, with worries about the strength of expansion and about possible fiscal policy outcomes resulting in both upward pressure on bond yields and downward pressure on stock prices in recent weeks.

Against the backdrop of these mixed signals, and of the downward revisions in the greenbook forecast of output and prices to or below the central tendencies of Committee members' forecasts in July, the decision that would seem to be posed today for the Committee is whether or not to reduce the federal funds rate another notch at this time. I thought I would address three of the issues that might have a bearing on weighing the costs and benefits of such an action: the monetary policy implications of the possibility of more stimulative fiscal policy next year; the potential effects of policy easing on tender financial markets, especially working through movements in the dollar; and whether and how easing might in fact have a stimulative effect on spending.

The uncertain dynamics and outcome of the election process may have widened the range of possible outcomes for fiscal policy. As already noted, concern and uncertainty about the fiscal outlook likely was an important factor behind the failure of bond rates to

follow short-term rates down over the intermeeting period. This situation presents potential difficulties for monetary policy. As markets build in the possibility of higher budget deficits, the resulting rise in long-term rates damps activity well before the actual, offsetting, fiscal stimulus arrives, if it ever does. In concept, one might be able to make monetary policy adjustments in the direction of offsetting the effects on nominal spending of the fiscal/financial market adjustments by easing now and perhaps tightening more later, if the fiscal stimulus turns out to be excessive. However, this degree of "fine-tuning" implies far more certain knowledge of the strength and timing of policy channels than we have. Short of this, the possibility of future fiscal stimulus would not seem to be a good reason to hold back from policy easing at this time, provided other considerations were seen as pointing in that direction.

Important among those considerations would be the effect of an easing on the exchange value of the dollar and on financial markets more generally. In light of the extraordinary volatility in foreign exchange markets and the sensitivity of stock and bond markets, the concern is that a further decline in interest rates might trigger, not an orderly drop in the dollar, but a generalized run that feeds on itself and shows through adversely to the prices of dollar assets. In writing the bluebook, we considered this possibility under alternative A. Clearly one can not dismiss the risk of substantial further declines in the dollar, especially were the economy to turn out even weaker than expected and monetary policy acted forcefully to counter that weakness. Indeed, if the U.S. authorities were outspoken in their indifference to dollar depreciation, as they have been at times, that drop could be steep and not very orderly, boosting bond yields

for a time. The key to whether the dollar decline would become oversized and have a more lasting effect on bond yields would seem to be the credibility of the System's inflation objectives. The danger is that the easing action would be perceived as signalling such an intense focus on promoting economic activity it raised questions about the Federal Reserve's willingness to lean against inflation pressures. In our view, the risks of this outcome would be fairly well contained if easing was clearly understood to be taken in the context of persisting high levels of slack in the economy and sluggish expansion of money and credit that pointed to considerable further disinflation. Market perceptions that the dollar is already undervalued against many currencies may help to limit further declines in response to appropriate easing actions. In these circumstances, lower federal funds rates are more likely to be accompanied by lower bond yields.

Having made this case, however, it's also important to note that the yield curve continues to suggest considerable skepticism about the prospects for holding inflation below previous trends once the economy recovers. Further easing is unlikely to contribute to convincing the skeptics. And they might be especially doubtful in light of heightened market concerns about outsized budget deficits over coming years, with potential pressures on the Federal Reserve.

In light of the possibility of adverse market reactions to a System easing, an assessment of likely benefits in terms of added spending is particularly important. Ted has discussed the exchange rate channel for policy influence, which remains operative, even if other forces restraining demand abroad are affecting our exports. Questions seem more pointed with regard to the effects of lower interest rates directly on spending. Many have noted the apparent damped response of the economy to declining short-term rates. Some of

this may represent the effects of exogenous factors, unrelated to interest rate levels, that would be depressing spending in any case. One such example would be decreases in defense spending. And other factors may have reduced the sensitivity of spending to interest rates. One would hope that the excess capacity in nonresidential structures would sharply limit the usual response of this sector to declining interest rates. In addition, earlier in the current cycle, the emerging credit crunch also played a role--effective rates for borrowers were not declining as much as observed rates, and might even have been rising after taking account of tightening standards and rising nonprice terms of credit. This seems less likely to be true this year; most reports suggest that credit tightening has stopped, at least outside of commercial real estate, so we ought to be moving down borrower demand curves as interest rates decline. Declining interest rates reduce the rewards for saving, encouraging current consumption and spending. But discomfort with existing balance sheet structures, particularly in light of concerns about future income prospects and about the future value of real assets, such as houses, probably are encouraging business and household borrowers to use additional cash flow to pay down debt rather than to spend on current consumption or to accumulate real assets. And, creditors may be reacting by raising saving to maintain incomes.

In these circumstances, the effects of lower interest rates on spending itself might be more delayed than usual, but in the interim they would speed the balance-sheet restructuring process, especially for borrowers. Particularly if lower short-term rates feed through to long-term rates, refinancing will be encouraged and asset prices--including that of equity--supported. As households and busi-

nesses increasingly become more compatible with their financial condition and adequately protected against possible adverse outcomes, they should begin to spend. And intermediaries would be better positioned to meet their credit demands. Perhaps what this suggests is an interest rate channel for monetary policy that is damped in the short run, but could operate with greater force over time.

If the Committee were to ease, it and the Board would be faced with the issue of the role of the discount rate in such an action. There is no technical barrier to pushing the funds rate below the discount rate. In the view of my predecessor, Mr. Axilrod, as noted in the Greenbook supplement, such a configuration might reduce the risks of excessive pressure on the dollar. The effect would be through signalling the Federal Reserve's intent that easing wasn't lasting or likely to proceed further for a time--similar to the signalling effect of intervention. But such an action would also raise questions and speculation as to why the Federal Reserve was changing long-standing practices at this time, perhaps confusing observers and providing grist for newspaper and newsletter mills. If the Committee wished to ease policy and there appeared to be a good chance that a discount rate cut might be forthcoming, it could acknowledge that possibility by adding a "taking account of a possible cut in the discount rate" to the first sentence of the directive. This is the language used in similar situations in the recent past.